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B-5350-3

The Manufacturers Hanover
Economic Report

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SEPTEMBER 1980

Is The Cycle Telescoping?

To listen to some observers, the business cycle appears to have suddenly been telescoped in time. What used to take years to happen now occurs in a matter of calendar quarters. And what used to take several quarters to take place now occurs in a matter of months — if not weeks.

Looking back on the first nine months of this year, it is amazing how widely (and violently) sentiment over the course of business has swung this year. Projections by economists for a recession notwithstanding, most businessmen, consumers and investors believed in January that no recession was in sight. By May, these same folks were looking for the end of Western Civilization as we know it, in view of the steep plunge in economic activity then under way. Now in September, sentiment has apparently swung once again toward the side of optimism, in that a growing number of people believe that the recession has ended and that recovery is now under way.

But this is not all. Along with this change in attitudes toward the economy has come a revival of inflation expectations and a turnaround in interest rates. Both of these have come at a rather unusual time. In the case of inflation, it follows in the wake of the best performance by the consumer price index for any month in 13 years. In the case of interest rates, it ignores past history since, even after recessions have ended, interest rates in both the short- and the long-term markets have generally continued to decline.

If interest rates and the inflation rate do rise, I would guess that by the turn of the year sentiment will once again be bearish. Even now homebuilders fear that the recent runup in mortgage interest rates will undermine the incipient recovery in new-home starts. Obviously, higher interest rates could affect a wide variety of other activities — including business capital investment and consumer spending on durable goods. Meanwhile, an upturn in the rate of inflation and the expectation of inflation would require a greater number of dollars to complete transactions than the Federal Reserve is apparently intending to provide to the domestic economy thus slowing aggregate activity for lack of liquidity.

On the fiscal front, things would seem to argue for caution as well. As I have pointed out in the past, the tax burden on most people will rise significantly in 1981 — tax cuts notwithstanding. Combined with inflation, this would seem to militate against any early revival in purchasing power both for business and consumers.

The Fed's Contribution

To what do we owe these rapidly-changing views? I can think of several reasons. The first was the unprecedented use of credit controls by the Federal Reserve earlier this year. Admittedly necessary to dampen the inflation psychology that was rampant, the Fed's program was widely misinterpreted. Rather than cutting down on use of credit, many people stopped using credit entirely after the Fed's policy package was announced on March 14, even though that was not its intent. The result was an unprecedented paydown in consumer debt to the tune of $9.5 billion in four months. This much credit has never been paid off in so short a period of time. It had the well-documented effect of causing the economy to fall like a lead balloon in the second quarter, since consumer spending accounts for two thirds of the GNP. It was this decline in use of debt that helped pave the way for an increase in consumer spending. People began to borrow again, once the credit controls program was lifted at midyear, allowing some deferred spending to take place.

This improvement in consumer spending should be kept in its proper perspective. August's level of retail sales, at $79.5 billion, was no higher than levels first reached last January. And this is in current dollars, unadjusted for higher prices. In "real" terms sales remain at least five per cent below their January levels. For this to be a consumer spending boom, sales are going to have to continue to rise. Yet those people who believe that a recovery is underway also believe that inflation is flaring up again, and if this is

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the case, I don't see how sales can continue to rise since people's buying power remains low, as does their stock of savings. What is more, business inventories seem high, and if business begins a program of inventory liquidation, it would result in production cutbacks and employee layoffs, thus further hindering any sizable improvement in consumer spending.

Sticking with the Federal Reserve, another aspect of Fed policy which has contributed to the greater volatility in the economy, is its emphasis on the monetary aggregates and its greater willingness to let money-market interest rates fluctuate in a wider band. The emphasis on the monetary aggregates is a good one, however, financial market participants tend to overlook just how the Federal Reserve is monitoring these aggregates. It may be true that the Fed has monthly and quarterly targets for the growth rate of the various measures of the money supply. However, these are only "fine tuning" targets to help the Fed achieve its annual objectives laid out earlier this year. Thus, even though the money supply has jumped sharply in recent weeks, M-1A and M-1B are still growing within the Fed's target ranges, while M-2 is only a tad above the Fed's 1980 target range.

The volatility part comes in because the weekly money supply numbers tend to be erratic. And because of this, financial market participants either mark up or mark down interest rates anticipating both the money supply numbers and the Fed's likely reaction to them. Finally, even if the Fed were able to mete out money at a steady rate week in and week out, interest rates would fluctuate because the demand for money is never constant. Whatever the case, the financial markets have become extremely jumpy in the past year, and this nervousness has been communicated to the rest of the economy.

Everyone Is Trying To Forecast

A third reason is sort of an outgrowth of the second, and that is that too many people are paying too close attention to every economic statistic. One of the first things that students learn in Economics I is that nothing moves in a straight line. These days, the minute a statistic changes direction, it is assumed to represent a major change either for that statistic, or for the economy. Economists are not alone in overreacting to changes in numbers. Many others are getting into the act, such as elected officials, businessmen and journalists. Little wonder that volatility has become the order of the day!

Personally, I think that a lot of this volatility in the economy is more apparent than real. The financial markets may change direction from day to day, but the economy doesn't. Once a recession gets under way, it has to run its course—and in the present circumstance, that means that business still has to address the problem of excess inventories. Given current rates of inflation and interest rates, not to mention the low rate of savings and the high use of debt, it seems unlikely that consumer spending can continue to recover the way it has done in the past three months. That being the case, business will have to liquidate inventories, and in the process, cut back output and lay off workers. Plainly, such a development would put a further crimp into consumer spending, thus keeping the economy in recession. As the decline continues, the underlying rate of inflation should moderate while interest rates should resume their downward course. Both of these developments would set the stage for a true recovery to get under way—but not before the beginning of 1981. H

Slow Growth Threatens The Global Economy

Although the worst of the U.S. recession appears to be over, the worst may yet come overseas. A number of trends both here and abroad are discernible, which if allowed to develop, could well lead to considerable economic difficulties in the next 18 months. Economic well-being hinges on two important factors: trade and capital investment. Both of these are endangered by recent developments.

In the United States we are somewhere past the middle of a middling recession and—although we can see the light at the end of the tunnel—the recovery which is anticipated looks to be slow and painful. The effects of this recession have been mixed. The rate of inflation has declined from its high point earlier this year, but at a "base" rate of over ten per cent it has become deeply entrenched in our economic system.

On the other hand, exports of goods and services have been a bright spot. In spite of the huge increase in OPEC oil prices (over 130 per cent since the beginning of 1979) and high global inflation rates, the U.S. trade deficit this year will be close to last year's $29.5 billion. The current account is expected to be in deficit this year by about $1 to $2 billion, also close to the 1979 deficit. This comparative stability in the balance of payments has resulted from a sharp drop in imports as economic activity in the U.S. declined. Exports have held up due to the weak dollar and a higher level of growth in the economies of most of our trading partners so far this year.

Yet the growth prospects of the other industrial countries for the rest of this year and next are becoming increasingly clouded as the sharp rise in the cost of oil imports leads to low growth, anti-inflationary economic policies. With low growth policies at home, these countries will look to the export sector to sustain their economies. Yet with the U.S. recession lowering

our import demand — not to mention boosting competition for export markets — the burden that will be placed on the export sector will grow significantly. Those economies whose structure is skewed toward heavy dependence on exports will suffer particularly.

The International Monetary Fund (IMF) in its most recent annual report predicts that real growth in the industrial countries of the free world will probably not exceed one per cent each year in 1980 and 1981. In 1979 real growth in the industrial nations was about 3½ per cent. As a result of the oil price increases, the current account deficits of the industrial countries this year may total as much as $65 billion — a major part of the anticipated $110 billion OPEC surplus. For the first half of 1981 a further $25-$30 billion aggregate current account deficit for the industrial countries seems likely. Some major economies are expecting substantial current account deficits this year: West Germany, some $14 billion and Japan, close to $17 billion. In 1981 these deficits, though smaller, will still be large.

World Trade Is Slowing

The prospects of low growth or recession in 1980 and 1981 followed by sluggish recovery in the industrial nations has important global implications for trade. The industrial countries of the free world account for some 72 per cent of total free world trade. As these countries struggle with the ever-rising cost of oil imports and low growth, the best that the volume of world trade may be expected to rise would seem to be about three per cent this year and next after a 6.5 per cent rise in 1979. Trade volume growth in the last decade has averaged almost seven per cent per annum. Since exports must equal imports worldwide, reductions in the rate of growth of world trade have a direct and profound effect on those economies (particularly the non-oil producing developing nations) who look to exports to generate foreign exchange for necessary imports, particularly oil, and debt repayment.

Yet another effect of low growth and the rising costs of imports is as a threat to trade liberalization. On the one hand, trade liberalization is encouraged as a means of promoting economic growth, adjusting payments imbalances and providing the means for social and economic development. On the other hand, as unemployment rises, current account deficits grow and bankruptcies in major industries threaten, protectionist sentiment rises — witness, the pressure for protection of domestic automobile industries against Japanese imports in the U.S. and EEC as one example. At the same time we have before us clear evidence of the role of quotas, high tariffs and other trade barriers in extending and deepening the worldwide depression of the 1930s.

Most profoundly affected by a decelerating growth in trade will be the less-developed countries (LDCs), many of which are almost totally dependent on exports of one or a few basic commodities for the foreign exchange needed to finance development. They have been particularly hard hit by a rapid degeneration in their terms of trade. Not only have oil prices skyrocketed, but prices of other imports, particularly of capital goods, have also risen rapidly, in recent years. At the same time, the prices which the LDCs receive for their exports have not risen as much. On top of this, the LDCs are now faced with the prospects of increased competition in exporting to a world with slowing economic growth. This will lead to pressure to reduce their export prices, exacerbating their financial difficulties.

Long-term changes in world trade patterns illustrate some of the problems of the LDCs. In 1960 exports of non-fuel primary products totaled nearly 40 per cent of the value of world trade, manufactures accounted for 50 per cent and fuels for 10 per cent. By 1979, non-fuel primary exports had dropped to 20 per cent of the value of world trade, fuels were 20 per cent and manufactured goods were 60 per cent. This shift in trade patterns has left the LDCs, which are heavily dependent on the export of these primary products, with a diminishing share of the world export market and of world export earnings.

LDC Debt Is A Problem For The Banks . . .

In an attempt to overcome the obstacles to development which uneven inflationary growth in export prices has created and under pressure from growing populations seeking higher living standards, the LDCs have turned increasingly to financial institutions, particularly commercial banks, for funds. These loans have been devoted not only to financing specific development projects but more and more in recent years to financing balance of payments deficits — not to mention paying interest on previously-incurred debt. Since the oil price shock of late 1973, aggregate LDC current account deficits have increased by about $200 billion. It is probable that the LDCs will be seeking at least $40 to $50 billion in additional financing this year and perhaps an equal amount next year in order to help finance the expected aggregate LDC current account deficit of $60 billion. Some portion of their financing needs will be met through borrowing from such official international financing institutions as the IMF, the regional development banks and the World Bank. Another portion will be supplied through bilateral government-to-government borrowing, while another portion will be generated by drawing down international reserves. But a very large portion, if not the majority of the LDCs financing requirements, will be sought from the multinational commercial banks.

In recent years, particularly since 1974, commercial banks have assumed an ever-increasing role in financing LDC public debt. As the cost of financing oil and other imports has become ever-more onerous, official sources of funds have become inadequate and in

some cases their lending conditions have been deemed too burdensome. The commercial banking system has been able to meet the need of the LDCs, and of other borrowers as well, through the efficient mobilization and reallocation of financial resources worldwide. This process has successfully withstood the wrenching stress placed on it in one direction by the enormous flow of financial assets into the hands of the oil producers and the equal stress of redistributing those assets and other financial resources to the debtor countries.

But the economic events of the last six years have taken most of the stretch out of the system. The ability of the international monetary system and the commercial banks to accommodate these new demands has about reached its limits. There is a very real question about the capacity of the multinational banks to continue lending to some of the LDCs because of legal limitations on lending to single borrowers, prudent portfolio management, capital adequacy and judgment based upon careful analysis of potential economic and political risks.

The major banks in the principal industrial countries now have in excess of $160 billion in claims on the non-oil producing LDCs—over half of the LDCs' estimated public and private external debt. One year ago the figure was about $130 billion. As oil prices and other import costs escalate, the LDCs' annual borrowing requirements will rise as well. At the same time, the ability of the banks to service these requirements will likely diminish. It is not yet apparent what new institutions will absorb this new debt and at what cost. As the level of debt rises, risk increases; as the demand for funds rises, so does the competition for the funds available. Both risk and demand are components in determining interest rates. As interest rates rise, the cost of servicing the debt adds to the burden of the LDCs. An ever-increasing percentage of LDC borrowing now goes to service existing debt rather than into new development projects.

In several cases, individual LDCs are now at or near the limits of their ability to borrow. Although outright default is rare, debt rescheduling is becoming more and more common. The debt of the LDCs is unevenly distributed with a few larger countries accounting for the bulk of it. Twelve LDCs accounted for about 65 per cent of total LDC debt at the end of 1979. A few of the very large LDCs are having increasing difficulty in financing their debt in the international financial markets, and the rescheduling of their existing debt is a growing probability.

. . . And OPEC Surpluses Are Growing

So far, this discussion has centered on the demand for funds. On the supply side the ability of the international financial system, particularly the banks, to recycle the OPEC investable surplus is another problem. It is commonly conceded that this surplus, expected to be close to $110 billion this year, will continue to be very large in the foreseeable future. Next year it is forecast to be at least $90 billion. Since 1974, as the size of the annual surpluses have waxed and waned, the international banks have been the principal vehicle through which these funds have been recycled. Given the limited number of ways in which these huge financial flows can be placed, there is no reason to think that this will not continue to be the case.

However, it is the banks acting as intermediaries who assume the responsibility for the allocation and security of these deposits. In a world of declining real growth, growing debt by the poorer nations, as well as economic and political instability, good investment opportunities are growing scarcer. As a result a "two-tier" market may well develop in which interest rates and maturity periods more closely reflect the perceived risks in individual loans. Higher interest rates and shorter loan periods for the LDCs will result. Another effect may be that a larger proportion of the surplus may be invested in the government securities of the major industrial nations, helping to finance their current account deficits, or in other real or financial assets in these countries. This would have the effect of reducing the supply of funds of the LDCs, further aggravating their problems.

The next 18 months would seem to be a critical period. Either more time will be bought for longer-term solutions to these problems, or there will be major economic (and possibly political) unrest. An extended period of global low growth, the introduction of protectionism, beggar-thy-neighbor economic policies, sharp cuts in living standards with the disappointment of social and economic aspirations, debt default by one or more or the LDCs with consequences for the international financial system—any or a combination of these could introduce a period of economic chaos. On the other hand, timely recognition of the risks and prompt remedial action can lead to stability and a return to growth.

It would be simplistic to blame the problems discussed above solely on the continuing rise in oil prices. Narrowly nationalistic political and economic policies, long-term structural defects in national economies, wide discrepancies in inflation and growth rates, and increasing competition for limited markets and resources have played their role as well. As long as these factors continue to exist, stable economic growth will be a chimera. New ideas and institutions will be required to meet the challenge of the times.

—William L. K. Schwarz, Vice President